DOW
PUBLISHING COMPANY
Sound advice for generations

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

CONVENTIONAL WISDOM?

One of my high school teachers used to proclaim that, as we proceeded with our educations, we progressed from questions of "what" to questions of "why." In the areas of financial and portfolio counseling, there are widely accepted dogmas which I suggest practitioners might more frequently examine by posing questions of "why." In spite of their having come to be accepted as a part of the conventional wisdom of investing, my purpose here is to challenge the logic of the following three doctrines:

1. That all investors should maintain a cash reserve (in a checking or savings account, a money market fund, or Treasury bills), as an "emergency fund," equivalent to three to six months of living expenses, over and above those funds normally held for these expenses, so that they will not have to liquidate other investments for an emergency at a potentially inopportune time.

2. That one's financial assets should be allocated such that the percentage invested in equities (common stocks) is equal to 100 minus his age.

3. That, in addition to diversifying the equity portion of his portfolio across industries and companies, an investor should "diversify" his portfolio across asset classes.

In challenging these three "generally accepted principles of investing," it is useful to recognize that there are basically three financial asset classes: cash, bonds, and common stocks. It is further useful to recognize that the returns on bonds historically, and over longer spans of time, have exceeded the returns on cash, and that the returns on common stocks have exceeded the returns on both cash and bonds. For the period 1926 through 1997, the average annual rates of return on three proxies for these asset classes have been as follows:

ASSET[1]	AVERAGE ANNUAL TOTAL RETURN
Cash	**3.8%**
Bonds	**5.2%**
Stocks	**11.0%**

Source: **Ibbotson Associates**

To proceed further with our challenge to the foregoing three dogma, we must also be willing to accept the assumption that, though future rates of return may well differ from the above, over longer periods of time, bonds will probably continue to return more than cash, and stocks will probably continue to return more than either bonds or cash. Just what the future rates or

[1]As its proxy for cash, Ibbotson uses 30-day U. S. Treasury-bills; as one proxy for bonds, it uses a U. S. Government bond with a maturity of 20 years; and, for large capitalization common stocks, it uses the Standard & Poor's 500 Stock Index for 1957-1997 and the S&P 90 for 1926-1956.

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

differentials may be is not germane to our discussion here; we need only have faith that meaningful differentials shall probably continue to exist, and in the same order.

Why have these differentials existed in the past, and why will they probably exist in the future? The explanation lies in the fact that capitalism is so structured that, the greater the uncertainty associated with the timing of a return for a given asset class, the greater must be the return available from that asset class. If investors did not reap a higher return for investing in an asset class with greater uncertainty in the timing of its returns, they would not put their money into that asset class, and so that asset class would cease to exist[2].

EMERGENCY FUNDS

Though the concept of maintaining a reserve in cash as an "emergency fund" is about as ingrained in the American psyche as baseball, motherhood, and apple pie, I believe the reasons usually promulgated for doing so warrant some questioning. Whenever I hear the cash reserve policy advocated I am reminded of the story of a small community with three taxis and a single hack stand located in front of the town hall. The community was a busy one, and the selectmen became frustrated with the frequency with which they could not procure a taxi for themselves because all three vehicles were in service.

In an attempt to solve the problem, the selectmen passed an ordinance requiring that there be at least one taxi waiting at the hack stand at all times, and that a lone taxi not be allowed to leave until another taxi had returned to replace it. For all practical purposes, of course, the town now had two taxis, instead of three.

Just as the selectmen's new ordinance incapacitated one of the town's three taxis, a reserve held perpetually in cash for events that occur infrequently, or maybe never at all, may reduce the efficiency of that part of an investor's assets so held.

At this point it seems useful to address the question of why we might be advised to maintain an emergency fund in the form of cash. There are two reasons usually proffered: (1) To provide "liquidity" in the event that cash is needed quickly, and (2) to preclude having to sell other investments at an "inopportune" time.

Liquidity: There are few assets more liquid than stocks and bonds. If one elects to sell a stock or bond today, the normal payout date is three business days hence; if one needs the money sooner, for an insignificant sacrifice in price, one can sell for "cash" or, for a nominal interest charge, one can get a "prepayment," and so eliminate even the three-day delay. Money can be "wired" from one's account to one's bank as "good funds" for use as cash on the same day

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

requested. A very common way to obtain quick temporary cash is to utilize a "margin" account whereby one borrows against his investment portfolio at a moderate rate of interest. This permits the disbursal of cash in an amount equal to up to half the value of one's portfolio on the day requested, without any need, at that time, to focus on whether to sell, what to sell, or when to sell. One can also have check-writing privileges on his margin account and so, effectively, have instant access to these funds. The "need for liquidity" as a justification for holding assets in the form of cash, as opposed to other financial assets, then, is a fiction.

An Inopportune Time to Sell: Implicit in the contention that one might be forced to sell securities to meet an emergency at an "inopportune time" is the arrogance that one can ever identify an "opportune" time to sell. If one believes he, I, or anyone else will ever know whether, from the point of view of timing the market as a whole or timing one investment in particular, it will be better to sell today, tomorrow, next week, next month, or next year, he is deluding himself with a second fiction.

There is one, and only one, good rule-of-thumb for timing one's investments and disinvestments: One makes investments when one has the money available to make them; and one disinvests when he wants to use the money for something else.

If one needs to sell securities to meet an unexpected emergency, he may end up selling when the market is high, or he may end up selling when the market is low; but he will never know whether the market was high or low until after the fact.

The belief that we can know today whether the market is truly high or low is an illusion. If, two years hence, we see the Dow-Jones Industrials two thousand points below where it is today, we shall, then, know that the market was high today; if, on the other hand, we see the market two thousand points higher two years from now, we shall, then, know that it was low today. Because we cannot sell securities retroactively, we can never know in advance whether a time to sell is opportune or inopportune. If we cannot ever know the answer to a question in time to make a decision, then, it is not useful to make addressing that question a part of our decision making process.

Furthermore, if over a lifetime we must sell securities on a number of occasions to meet unexpected expenses, we shall subsequently learn that sometimes we sold when the market was low and sometimes we sold when the market was high but, as the saying goes, "it will all come out in the wash."

In my financial planning readings on "emergency funds," I came upon the following caveat that amuses me to no end:

---

[2] This relative degree of uncertainty is measured for bonds with some precision (and used as a measure of their interest rate sensitivity), and sometimes guesstimated for common stocks, with a tool called "duration." Bonds and common stocks are, therefore, often referred to as "long-duration" assets.

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

> It is important that clients recognize that the money drawn for emergencies from established emergency funds must be replaced as soon as possible to manage future emergencies.

In other words, once the emergency fund is disbursed, there is no longer any emergency fund, and so one needs to liquidate other assets at the time of the emergency, or "as soon as possible" thereafter, to recreate the fund. If one is going to have an emergency fund at all times, then, one is precluded from taking into consideration the "opportuneness" of his sale of other assets to replenish the fund. But this is no different from what he would need to do if he had no cash in an emergency fund in the first place. He must sell his other assets, if, when, and as emergencies arise either to meet the emergency or to replenish the emergency fund.

The Downside of A Cash Reserve: As alluded to earlier, money held in a cash reserve is not as productive as money held in longer-term assets. To use a simple example:

Let us assume that the three to six months of living expenses that we are instructed to hold as cash for an emergency amounts to $25,000, and that we are planning over a twenty-five year time frame. Using the historical data in the table above, the difference between the earnings on $25,000 over twenty-five years when invested at 11.0%, versus being invested at 3.8%, is $276,122. This price, in excess of $1/4 million, seems like quite a lot to pay to maintain a $25,000 cash reserve.

All of the foregoing notwithstanding, money that may be needed in the near-term for any purpose should not be put into a tax-deferred retirement account such as a 401(k), and it should not be put into a traditional IRA if one is under age 59½. Funds in a 401(k) may not be accessible at all for an emergency; and funds withdrawn from a traditional IRA before age 59½ may be subject to a 10% penalty tax.

As long as one has his readily accessible financial assets invested in publicly traded, marketable securities (as opposed to limited partnerships or shares of a closely held corporation which are not readily marketable), he should feel they constitute his emergency fund, whether those securities are invested in cash equivalents, bonds, or stocks. Furthermore, if one is over age 59½, even all those marketable securities in his IRA may be considered as part of his emergency fund.

In the final analysis, I have no problem with anybody's maintaining a cash reserve, and in any amount with which he is personally most comfortable. I merely think that the foregoing two reasons, promoted by so many financial advisors, are not appropriate reasons for doing so.

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

DOW
PUBLISHING COMPANY
Sound advice for generations

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

THE ASSET ALLOCATION FORMULA

Of all the prescriptions dispensed by financial advisors, that of investing in equities that percentage of one's financial assets equal to 100 minus one's age must be among the most absurd. About the only thing this formula has going for it is that it is easy to apply. Most people know their own age, and subtracting that number from 100 is not a cumbersome task.

Why the number from which we should subtract is 100, and not 50, 500, or, perhaps, the universal constant of gravitation (6.67×10^{-11}), has not been made clear to me. Nor do I yet understand why, from whatever that magic number may be, we should subtract our age, as opposed to our height, our weight, or, perhaps, our Social Security number.

Age as a Criterion: I have great difficulty in understanding why "age" should have much bearing on how one invests his money. The argument, of course, goes that young people can better cope with volatility in their investments because they have more time to allow for a portfolio recovery following a portfolio decline, and so they should own more common stocks than older people should.

There is, however, a countervailing argument. The foregoing conventional wisdom assumes that the only risk for an older person with respect to his investments is that of a decline in their value. It is my experience, however, that older people have more often felt themselves victims of inflation and declines in the purchasing power of their investments than declines in the nominal value of those investments.

And who is better able to cope with inflation? A young person whose wages will probably at least track the Consumer Price Index, or an older person who must now live on his accumulated savings?

Inflation has traditionally been addressed with equity investments and not much else; hence, I can see, here, a better argument for an older person to invest more heavily in equities than for a younger person to do so.

Degree of Affluence as a Criterion: Another commonly accepted basis upon which to determine what portion of one's assets are appropriately committed to equities is to relate the decision to one's overall level of affluence. The greater one's personal wealth (his cushion of comfort), presumably, the more tolerant that person will be of volatility in the value of his financial assets.

Except insofar as older people tend to be more affluent than younger people, age is not a consideration with respect to this criterion.

Time Horizon of the Portfolio: In my opinion, by far the most logical and useful standard by which to determine an appropriate allocation of common

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

stocks to a portfolio is the "time horizon" of the portfolio.

If a sum of money is earmarked for a college education scheduled to begin next year, it is probably not appropriate to invest the money in either stocks or bonds. Similarly, the proceeds of the sale of a house which are to be used for the purchase of another house are probably funds best held in an interest-bearing cash account.

Using the "time horizon" criterion, one rule-of-thumb for deciding whether or not it is appropriate to invest a particular sum of money in common stocks is to ask if there is a greater than fifty percent probability that the money will stay invested for more than five years. If the answer is "yes," common stocks may be appropriate. Historically, the probability of experiencing a positive return on money so invested over time spans exceeding five years has been quite high[3].

The time horizons of most investment portfolios tend to be quite long. The time horizon of one's IRAs should probably be considered to be longer than the time horizon of his taxable account. That is because it is usually wiser, in retirement, to deplete completely one's taxable account before withdrawing from his IRA (subject to the minimum withdrawal requirements of the latter), in order to preserve the tax-deferral benefit for as long as possible.

If one is depending upon his portfolio as a source of retirement income, that portfolio should be considered to have a time horizon no shorter than its owner's life expectancy. In the case of the portfolio of a married couple, the time horizon should be no shorter than the life expectancy of the second to die. The life expectancy of a single person, age 65, is 20 years; and the life expectancy of the second to die of two people, each age 65, is 25 years. To the extent that one cares to prepare for the possibility of living beyond his life expectancy, the time horizon for his portfolio is even longer than that derived from the life expectancy tables.

Finally, to the extent that one believes his investment portfolio will outlast himself, to be passed on to his heirs, its time horizon may go far beyond his own lifetime and, for all practical purposes, become infinite.

The time horizon of a portfolio seems a far better criterion for determining how the portfolio should be invested than either the age or affluence of its owner, though the latter two variables may, indeed, help determine the former. Nevertheless, using the time horizon criterion, and the five-year rule-of-thumb, there are relatively few portfolios that are not eligible to be invested predominantly or wholly in common stocks.

[3] Over the 72-year period 1926 to 1997, 60 (90%) of the 67 five-year holding periods have shown positive returns. Over the 55-year period, 1942 to 1997, 48 (96%) of the 50 five-year holding periods have shown positive returns. (I pray that my reader may find the basis for this "50%-five-year" rule-of-thumb logically and empirically more robust than the "100-minus-age" rule-of-thumb herein disdained.)

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

DIVERSIFICATION ACROSS ASSET CLASSES

My initial discomfort with the concept of diversifying across asset classes lies in the terminology. Traditionally, allocating one's portfolio among stocks, bonds, and cash has been referred to as "balancing" the portfolio. "Asset allocation" is a more modern and, arguably, more appropriate term.

"Diversification" is a term perhaps better reserved for the deployment of one's assets among different investments in the same asset class and, so, among investments with comparable risk/return profiles. One diversifies a common stock portfolio by purchasing the common stocks of different companies and in different industries, and he diversifies a bond portfolio by purchasing the bonds of different issuers. In the case of municipal bonds, good diversification will probably imply issuers in different parts of the country.

A more descriptive term for what is commonly called "diversification across asset classes" is "hedging." If one holds cash to complement his common stock portfolio, he is not "diversifying" in the traditional sense; he is attempting to "hedge" or mitigate the volatility of returns associated with common stock ownership. If he complements his long-term bond portfolio with some intermediate-term or short-term bonds, he is "hedging" against the greater volatility characteristic of long-term bonds. Similarly, if he complements his bond portfolio with common stocks, he may be "hedging" against the erosion of the purchasing power of his portfolio associated with inflation.

The significant difference between "diversification" and "hedging" is that, while diversification implies the addition of investments with similar risk/return profiles in an effort to tame portfolio volatility, "hedging" may imply the acceptance of a lower rate of expected return in exchange for a lesser degree of volatility. Hedging, of course, is a more effective way to reduce the volatility of a portfolio, but it is also a more expensive way of doing it.

This, I believe, is what many investors fail to realize and many financial advisors fail to point out. While diversification within an asset class provides a "free lunch," "hedging" with less volatile assets can be very expensive. As to how expensive, one need only refer to the example previously cited of the more than $1/4 million foregone by the individual who hedged the volatility of his portfolio for twenty-five years by holding $25,000 in U. S. Treasury bills instead of in common stocks.

If one can learn to differentiate between "diversification" and "hedging" and recognize that, while "diversification" is free, "hedging" may be expensive, he will have made a quantum leap in understanding the management of money.

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.

dows.com
358 US Route One, Falmouth, Maine 04105
207.878.3000 ■ 800.578.9981 ■ info@dows.com

CONCLUSION

In the last analysis, to ask our financial advisor how much of an investment portfolio should be held in the form of cash and/or bonds is akin to asking our doctor how much salt we should add to our food. The financially or medically best answer to these respective questions may be that none is best, but as little as possible, in any case. As a result, we will arrive at a level of salt that will help preserve our health, but also preclude our giving up food; and, hopefully, too, we will arrive at a balance among equity and fixed income investments that will permit us, not only to prosper with our investments, but to be comfortable with them as well - or, to use a common cliché, to enable us, not only to eat well, but also to sleep well.

Clifford G. Dow, Sr., CFA, CHFC, CFP®
Chief Investment Officer
1998

Securities offered through Delta Equity Services Corporation. Advisory services offered through Delta Global Asset Management, an SEC Registered Investment Advisor. 579 Main Street, Bolton, MA 01740 978.779.5361 FINRA SIPC MSRB

Copyright ©2007 Dow Publishing Company, Inc. All Rights Reserved.